

November, 1981

U.S. BUSINESS OUTLOOK, SHORT-TERM

Mushy and indecisive for half a year, the U.S. economy is now turning distinctly softer--retail sales have slumped, industrial production is down, capital spending plans are modest at best. The imploding housing industry, meanwhile, sinks deeper into depression while autos run into another wall of consumer resistance.

In short, the U.S. is in recession.

True, the economy grew 0.6% at an annual rate last quarter. But it fell 1.6% the quarter before; and in 1981's fourth quarter, McGraw-Hill forecasts a sharp drop in inflation-adjusted gross national product (GNP) of about 6%. A further decline is then foreseen in the first quarter of 1982.

The recession reasoning, very simply, is that no major sector promises to provide the economy with any strength. High interest rates have devastated housing and autos (when rebates weren't in effect) for many months, and there was no recession. But during that time, consumer spending on nondurables and services and business spending on inventory and capital goods kept the economy away from the precipice. Those fortifications appear to have crumbled for the moment, and no others--such as exports or government spending--have taken their place.

Beyond the moment, however, and beyond an inventory correction in the first half of next year, economic activity is expected to

spurt--driven by the second round of Reagan tax cuts and by a decline in interest rates. In the second half of 1982 all major private sectors of the economy--housing, consumption, business investment--should be enjoying an upswing.

On a more sobering note, the economy will have sunk so low in the first half of 1982 that economic growth for the year as a whole is put at an anemic 0.1%. (The forecast also implies that in the twelve quarters starting with 1979's first quarter, growth will have been virtually nil.) In particular, even though housing is expected to make a comeback, it will remain at a low level in 1982. And as for the rest of the economy, the Reagan boom will have to wait til 1983.

Some Good News (Maybe) for Housing

The bad news from the economic front is that, despite a little growth in the third quarter, real GNP was still 0.2% below 1981's first-quarter level. The worse news is that real GNP is expected to plummet in the current quarter and to dip again in 1982's first quarter, thereby dragging real GNP 2% below the previous peak. That would make this recession about average for the post-World War II period, as shown in Chart I.

Chart I. Post-War Recessions

<u>Recessions</u>	<u>% Decline In Real GNP</u>
1948-49	-1.5%
1953-54	-3.2
1957-58	-3.3
1960-61	-1.2
1969-70	-0.7
1973-75	-4.8
1980	-2.6

The good news is that interest rates are coming down, and should continue to fall as a weakening economy depresses loan demand. The better news is that the interest rate decline should lift housing off the floor...which may not be saying much, considering that housing starts this quarter are expected to reach a post-war low of 825,000 units (annual rate).

Nonetheless, instead of whacking the economy even further, housing next year should be supplying some strength. That strength will become sizable around mid-1982, by which time the starts pickup earlier in the year will begin to snowball into increasing construction expenditures.

Two assumptions underlie this forecast: One, high mortgage rates have forced a lot of would-be housebuyers out of the housing market in the past two years; two, enough of these people will soon jump into the market so that builders will go back to work. The first assumption clearly seems accurate: From 1977 through 1979 the U.S. started an annual average of 1.9 million houses; with the onset of recession and rocketing interest rates, starts in 1980 and 1981 will average only about 1.2 million. So a heavy backlog of (unrealized) demand seems to have developed.

On the other hand, assuming that an easing of mortgage rates will convert this backlog into a spurt of (realized) demand is more questionable, given that rates will probably not fall below the 14%-15% range.

As a bit of guide to what might happen, take a look at Chart II. While factors other than mortgage rates (personal income, for example) obviously play an important role in determining housing starts, the chart does suggest that people "got used to" a higher level of mortgage rates

Chart II. Housing Starts and Mortgage Rates

<u>Year</u>	<u>Housing Starts (Thousands)</u>	<u>Mortgage Rate (%)</u>
1965	1434	5.81
1970	1338	8.45
1971	2052	7.74
1972	2357	7.60
1973	2045	7.95
1974	1338	8.92
1975	1160	9.01
1976	1538	8.99
1977	1987	9.01
1978	2020	9.54
1979	1745	10.77
1980	1292	12.65
1981	1090	14.80

NOTES: Mortgage rate is annual average effective rate on newly-built single-family homes. 1981 figures are McGraw-Hill estimates.

as the 1970s wore on. The implication is that more people may soon be willing to take on mortgages, even at 15%.

The message here, however, is that the housing market--whose recovery is crucial to overall economic recovery--is outside of historical experience; ergo, the uncertainties of economic forecasting are complicated moreso than usual. The safest statement to make is that mortgage rates will soften and thus housing starts should bottom out within the next couple of months, showing some pickup after that. But whether starts can rise quickly in the second half of 1982, as forecast, is less certain. And even if they do, the 1982 average will be merely 1.2 million, making it another dismal year for housing.

The Consumer is Cautious

Crucial to McGraw-Hill's forecast of a tumbling economy in late 1981 and early 1982 is consumer behavior: The October tax cut notwithstanding, consumers appear cautious and thus ready to keep their bank accounts up and borrowing down for the next few months. In fact, consumer spending is expected to slump 5%-6% (annual rate) in real terms this quarter, thereby contributing mightily to the recession. Moreover, because the consumer cutback will prevent business from paring inventories (which are too high relative to sales), inventories will get trimmed in the first half of next year. And this trimming will cause real GNP to dip in 1982's first quarter, even though real final demand (demand from end users) is forecast to rise,

What is the evidence to support such a sharp consumer retrenchment, especially when the consumer has been so resilient in recent years? In part, the answer can be read in Chart III, which presents some salient

Chart III. The Consumer: Ready to Cut Back

Year and Quarter or Month	----Billions of Dollars*----		-----Percent-----		
	Net Change In Consumer Installment Credit	Change In Disposable Personal Income	Savings Rate	Unemployment Rate	Prime Rate
1979 I	\$47.1	\$49	5.3%	5.8%	11.8
1979 II	38.3	33	5.6	5.7	11.7
1979 III	38.2	51	5.4	5.8	12.1
1979 IV	31.0	46	4.7	5.9	15.1
1981 I	23.9	51	4.6	7.3	19.2
1981 II	22.4	38	5.4	7.4	18.9
1981 III	30.5	56	5.1	7.2	20.3
October	NA	25**	6.5	8.0	18.5

*Seasonally adjusted annual rates.

**Change from September. Other figures in column are quarter-to-quarter changes at seasonally adjusted annual rates.

statistics on the consumer now compared to 1979. (Recall that in 1979 consumer spending was holding the economy back from recession, which finally hit in the first part of 1980.)

The main similarity between the 1979 and 1981 consumer situation is that the savings rate is low in both. (A "normal" savings rate would be 6%-7%.) But note the jump in October, 1981 as consumers saved a big chunk of their tax cuts.

Among the dissimilarities is the rapid roll-up of consumer debt in 1979 versus a relatively conservative approach to debt in 1981. (Even the largish debt increase in 1981's third quarter may be a fluke, since it mostly represents auto credit, which in turn reflects consumers' taking advantage of auto company rebates in August and September.) Fostering consumer conservatism in 1981 is the high level of interest rates--rates much higher than in 1979.

The other large statistical disparity between the two years is in the unemployment rate, steady at under 6% in 1979 while currently at 8% and pointing upward.

By the end of 1979 it was clear consumers could not continue to bolster the economy, although it took government-mandated credit controls a few months later to push consumption off a cliff. In contrast, consumers this time around are expected to do their belt-tightening unaided: The low saving rate implies increased saving, thus relatively less consumption; since interest rates (though falling) are still high, caution on debt is expected to continue, so that no big debt-financed consumption gains can occur; and the specter of unemployment should make consumers especially wary of extending themselves financially.

In sum, though the consumer debt burden is lighter now than it was just before the 1980 recession, the low saving rate and high interest and unemployment rates signal a retrenchment. It won't be as bad as 1980, when the hullabaloo over credit controls made consumers afraid to look at their credit cards. But it will push the economy into recession, and then force an inventory rundown that will keep economic growth down for another quarter or two.

When the 10% tax cut coupled with increases in Social Security payments hit next July, however, consumption should take off. And by the first quarter of 1983, the real level of consumption should top 1981's first quarter level by 3%-4%.

Capital Spending Capsizes

Last August, when the Economic Recovery Tax Act of 1981 became law, the Administration hoped the new depreciation and other pro-investment measures would stimulate vigorous capital spending programs. And economic forecasters, while not expecting a full-fledged capital spending boom in 1982, did look for substantial gains of 13% to 15%.

But now, as the economy grapples with recession, the prospect of a vigorous capital spending thrust grows smaller and smaller. Numbers supporting those diminished expectations are displayed in Chart IV. (Additionally, a recent McGraw-Hill survey found that U.S. business plans no increase in capital expenditures in 1982, after accounting for inflation.) In a nutshell, Chart IV says demand for capital goods is going nowhere, while at the same time financing of capital projects faces tough sledding.

What the chart doesn't show is that firms typically cut back capital spending only after they perceive a downturn in the economy; thus they can help keep the economy from a steep fall at the beginning of recession. For example, even though the economy wobbled in the second

Chart IV. Capital Spending Indicators Point to Near-Term Weakness

	-----Quarters of 1981-----		
	<u>1Q</u>	<u>2Q</u>	<u>3Q</u>
Non-Defense Capital Goods Orders (Billion \$)	281.9	287.3	286.6
Construction Contracts-Commercial and Industrial (Millions of Square Feet)	1012.3	979.7	866.3
Corporate Cash Flow (Billion \$)	282.4	270.5	275.9
Gross National Product (Billions of 1972 \$)	1516.3	1510.2	1513.1
Business Equipment Output (Billions of 1972 \$)	112.7	114.9	113.7
Industrial Operating Rate (%)	77.9	76.9	76.3
Interest Rate on Corporate Bonds (%)	14.4	15.2	16.3

NOTE: Dollar and square foot figures are at seasonally adjusted annual rates.

and third quarters of this year, real nonresidential fixed investment held up.

By now, however, after a half year of economic weakness, real capital spending is due for a fall. Moreover, purchases of new plant and equipment will not likely burgeon until mid-1982, when renewed demand and

eased financial conditions will allow companies to make better use of the new investment inducements.

As investment opportunities multiply in the second half of 1982, the Tax Act--designed to jack up company cash flow by some \$30 billion over the next two years--should give rise to a capital spending surge in 1983. Right now, however, the tax incentives to invest are more than matched by the stronger disincentives of deteriorating demand and financial constraints.

The Budget Brouhaha

All of the above may seem reasonable enough, taken one piece at a time. Yet, if the doomsayers are right, this year's (and next year's and the next year's) federal budget deficits will overwhelm all positive forces in the economy, casting the scenario presented in this report under a cloud. The appropriate analysis would then be: Continuing budget deficits of \$60 billion or \$80 billion or \$100 billion will put such pressure on financial markets that interest rates will remain sky-high in the near term, and shoot even higher later on when even heavier government borrowing takes place. As a consequence, the economy will fizzle until taxes are raised or government spending is slashed. And since there is no immediate prospect for either, the recession will be steep and long.

The McGraw-Hill forecast obviously does not fully subscribe to this view of the world. For sure, the deficits are worrisome, and will prevent long-term interest rates from dropping significantly. But huge Treasury borrowings notwithstanding, rates will drop.

One reason rates will drop is that businesses will reduce their credit demand as they run off inventory and delay capital projects. Secondly, the cautious consumer will be in no mood to borrow a lot; on the contrary, people will likely increase their savings. Thirdly, the inflation rate is expected to decline as the economy weakens and as good harvests and plentiful petroleum supplies keep food and energy price increases down. As inflation moderates, the premium lenders build into interest rates will subside somewhat. In the fourth place, rates may decline because the Federal Reserve Board could ease its rein on the money supply and still hit its growth targets for the key M1-B measure of money.

But what about the deficit?

Well, in years of feeble economic growth federal deficits are usually big. For example, Chart V shows that it has not been unusual for the Treasury to garner a fifth or more of all nonfinancial sector funds raised in U.S. credit markets. So with markets supplying

Chart V. U.S. Government's Share of Total Credit Raised

<u>Selected Recession Years</u>	<u>Government Share (%)</u>
1953	23.8%
1958	22.0
1975	40.5
1980	21.7
1981 (first half)	21.3

NOTE: Data refer to funds raised by nonfinancial sectors.

\$400-\$500 billion in 1982, financing even a \$100 billion deficit would not throw Treasury borrowing out of line with history. The government

borrowing requirement in 1982, therefore, is viewed as manageable, leaving room for interest rates to subside modestly and for the economy to rebound.

Beyond 1982, however, persistence of huge deficits will likely truncate the expansion. If the government continues to absorb a quarter of credit market funds at the same time that business is borrowing to build inventories and to buy plant and equipment, then something has to give. And that something won't be the government.

To avert a financial crisis in late 1982, the Fed could try to rev up the money supply. But that would set off the inflation expectations of market participants and put the economy into the same predicament that Reagan and Volcker promised to rescue it from.

The alternative to monetary speedup, then, appears to be further budget cuts, cuts that of necessity would have to slice into the sacrosanct realms of defense and Social Security. Absent that, the alternative is for Reagan to renege on the tax cuts scheduled for July 1, 1982 and July 1, 1983. Such a decision, however, would remove the rockets that are set to boost the economy out of recession next year and into a high-growth orbit the following year.

Hence, the policy choice seems to weigh in on the side of further budget cuts. If the cuts don't come as expansion takes hold in 1982's second half, then the outlook for 1983 will darken as big deficits crimp private financing and raise inflation expectations (thus interest rates). In particular, the prospective capital spending boomlet could be throttled if in 1983 the Treasury giant casts its long shadow on credit markets for a fourth year in a row.

Summary

Depression in the housing and auto markets--the result of super-high interest rates--rendered the economy weak for most of the year. And yet, there was no clearcut recession in the economy as a whole. Reason: Other parts of the economy--like consumption of nondurables and services and business investment in inventories and capital goods--propped the economy up.

Housing and autos are still in depression. But now the support beams are collapsing, and nothing is left to prevent the economy from falling. What's more, even though consumption is expected to recover early next year, rundowns of business inventories will extend the recession into the first part of 1982.

The silver lining here is that interest rates will drop, thus giving rise to a housing recovery. And as increased housebuilding teams up with tax-cut-induced surges in consumer and capital spending later in 1982, the economy should go through several boom quarters.

But the tarnish on the silver lining should not be overlooked: Despite strong growth in the second half of next year, real GNP in 1982 as a whole is forecast to show little or no gain over 1981. In particular, even a relatively robust housing snapback next year will leave the housing industry in a sub-par position.

More ominously, the entire economy may be threatened in 1983 if the government does not successfully resolve its budget deficit dilemma: The 1982 Reagan recovery could quickly turn into another Reagan recession, possibly killing off all hope that the present Administration can do anything to assuage America's economic unease.

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	<u>NATIONAL PRODUCT ACCOUNTS</u> (Billions of Dollars)	
	Actual <u>1981</u>	<u>1981</u>
<u>National Product Accounts</u>	<u>3Q</u>	<u>4Q</u>
Gross National Product	2956.6	2980
Consumer Spending	1887.2	1904
Gross Private Domestic Investment	459.1	449
Fixed Investment	434.8	429
Nonresidential	333.2	335
Residential	101.6	94
Inventory Change	24.3	20
Government Purchases	588.3	607
Federal	226.0	237
State & Local	362.3	370
Net Exports	22.0	20
Real GNP (1972 Dollars)	1513.1	1490.9
(% change at annual rate)	0.6	-5.8
Implicit Price Deflator		
(% change at annual rate)	9.5	9.5
<u>Key Economic Indicators</u>		
Unemployment Rate (%)	7.2	8.3
Housing Starts (thousands of units)	969	825
Consumer Price Index		
(% change at annual rate)	11.9	10.0
90-Day Treasury Bill Rate (%)	15.05	11.0
1A Bond Rate (%)	15.07	14.8
Consumer Durables Spending	237.9	232
(billions of dollars)		

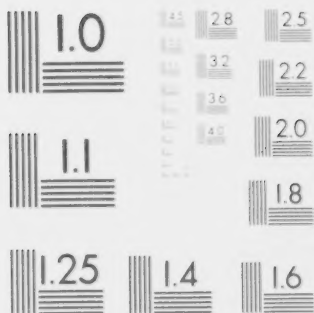
Data other than interest rates are seasonally adjusted at a

November, 1981

ACCOUNTS AND KEY ECONOMIC INDICATORS
(Billions of Dollars)

-----Forecast-----					-----Annual-----		
1982				1983			
1Q	2Q	3Q	4Q	1Q	1980	1981	1982
3028	3097	3210	3321	3438	2626.1	2918.8	3164.0
1960	2009	2069	2125	2187	1672.8	1857.6	2040.8
431	445	484	519	558	395.3	450.9	469.8
434	450	477	507	538	401.2	432.9	467.0
342	352	365	383	403	295.9	327.2	360.5
92	98	112	124	135	105.3	105.7	106.5
-3	-5	7	12	20	-5.9	18.0	2.8
617	625	638	658	673	534.7	587.3	634.5
241	245	253	263	270	198.9	226.0	250.5
376	380	385	395	403	335.8	361.3	384.0
20	18	19	19	20	23.3	23.0	19.0
1486.0	1491.6	1517.3	1538.8	1562.6	1480.3	1507.4	1508.8
-1.3	1.5	7.1	5.8	6.3	-0.2	1.8	0.1
8.0	7.8	7.8	8.3	8.0	9.0	9.2	8.3
8.9	8.7	8.4	7.8	7.5	7.1	7.6	8.4
950	1100	1325	1450	1650	1304	1090	1206
8.5	7.5	7.9	8.0	8.2	13.5	10.4	8.8
9.5	9.0	9.5	10.5	12.3	11.4	13.8	9.6
13.5	13.0	12.5	12.8	13.0	12.0	14.3	13.0
239	245	263	273	282	211.9	234	255

n annual rate.



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U.S. BUSINESS OUTLOOK, SHORT-TERM

Recession persists, but should end soon. Economic expansion is sure to follow, fueled by personal tax cuts and Social Security benefit boosts in July. Ergo, the economic prescription seems to call for rose-colored glasses.

Sound like Valentine-tinged overstatement? Not for 1982 it isn't. By the second half of the year businesses will have run down inventories about as far as they can go; Defense Department expenditures will be rising; and most important, consumers' purchasing power will jump by billions of dollars thanks to the tax cuts and Social Security increases.

In response to the reviving economy and in order to take advantage of the new pro-investment tax laws, business is expected to step up its purchases of new plant and equipment. And even investment in housing is expected to build up as interest rates slide marginally.

But keeping the rose-colored glasses on too long would surely, at some point, obscure one's vision of the future. And that point could come sooner rather than later. For even as the economy starts visibly improving, the course of the federal deficit and of the money supply will less visibly be determining whether 1982's recovery turns into a true expansion or into the third recession in four years.

Short-Term Sanguinity, Sort of

Gross national product (GNP), adjusted to remove the effects of inflation, plunged by more than 5% at an annual rate in the final quarter of 1981. And it was poised for another dive in the opening quarter of 1982. The reasons: Ongoing depression in housing and autos; further cutbacks in business inventories and in capital spending; and snowed-in, rained-on, iced-over consumers unable to do as much shopping as usual.

The weather, though admittedly more difficult to predict than the economy, will nonetheless improve, and consumers will raise spending. Once excess inventories are worked off, there will be no need for further inventory reduction--thus, output and employment levels will stop going down. And if mortgage rates decline a little, as expected, it will take a bit of the chill off housing. At the least, housing should stop dropping like a brick.

Then with personal tax cuts and Social Security pay hikes putting more than \$40 billion (annual rate) into consumers' pockets come July, the economy should get a boost in the ensuing months. At the same time that consumers are feeling more flush (a feeling that, incidentally, should help car sales), house builders should be raising expenditures on structures started in earlier months. Meanwhile, the growing pace of economic activity is expected to encourage business to buy new plant and equipment; features of last August's tax act--faster depreciation, for example--should also spur companies to hike capital expenditures once the economy shows signs of life.

The forecast calls for this economic momentum to roll forward into next year. By the first quarter of 1983, according to the statistical

scenario at the end of this report, real GNP will be 4% higher than in 1982's first quarter.

One fly in this soothing ointment is that the projected four-quarter growth is weak compared to previous recessions (see Chart I).

Chart I. Past Economic Rebounds

<u>Period</u>	<u>Real GNP Growth (%)</u>
1954-55	7.4%
1958-59	6.9
1960-61	6.4
1970-71	4.7
1975-76	6.7
1980-81	3.2
1982-83 (forecast)	4.1
Average excluding 1982-83	5.9

NOTE: Growth is the percent increase in real GNP four quarters from the recessionary trough. E.g., the 1953-54 recession touched bottom in the second quarter of 1954; real GNP in the second quarter of 1955 was 7.4% higher than in 1954's second quarter.

Another unpleasant observation is that economic growth from the first quarter of 1980 to 1983's first quarter is estimated at less than 3%. That averages out to under 1% growth a year, a paltry performance. Thus, rapidfire recessions in 1980 and 1981 have knocked the economy far off its trend growth path of 3%-3.5% a year. (For corporations in particular, the recessions undermined profits and led to a big pileup of debt--thus companies will be faced with major debt repayments once the recovery begins.)

More unsettling than these growth figures, however, are the questions that the back-to-back recessions raise about the underlying stability and vigor of the American economy: Is the U.S. in for a

sustained period of erratic economic performance, marked by short bursts of growth followed by renewed recession? Will growth on average slow down significantly or cease altogether? Will persistent high unemployment become a hallmark of the economy? If the answer to these questions is "yes," many American companies will have to scrap the business plans they've drawn up to guide them through the next several years.

In 1982, then, there is much to be pleased about--namely, the economy will spurt ahead in the second half of the year; but there is also much cause for worry, worry that could turn to reality uncomfortably soon.

Feeding on Fears of the Fed

All the fears and worries about the future of the economy can be summed up in two words--interest rates.

Not only are interest rates too high--far too high for the latter stages of a recession--but there is little prospect they will slump significantly. Yet the assumption of just a small dip in rates is important to the forecast, because even that would allow improvement in housing, autos, and other consumer durables, thereby giving a lift to the economy as a whole. At the least, a flattening of interest rates would help prevent further deterioration in housing and durables.

But why should rates come down? If anything, despite the recession, they seem headed up--after all, in February banks raised the prime from 15.75% to 17%. The answer is that loan demand should weaken; at the same time, it is assumed the Federal Reserve Board, while monitoring the money supply closely, will not squeeze excessively hard.

Supporting the view that loan demand will trickle down is not too difficult: With firms paring inventories, capital projects, and payrolls, their need for funds should be falling.

History (see Chart 2) also suggests that loan demand will be weakening at this stage of the recession.

Chart 2. Recessions Usually Damp Loan Demand

-----Loan Demand in Billions of Dollars-----			
<u>Recession</u>	<u>First Month of Recession</u>	<u>Maximum During Recession</u>	<u>Month After Trough</u>
1953-54	\$ 21.9	\$ 21.9	\$ 20.7
1957-58	30.4	30.4	28.2
1960-61	32.6	33.1	33.1
1969-70	83.2	86.2	83.6
1973-75	102.0	125.2	120.9
1980	162.2	162.2	162.8

NOTE: Loan demand is commercial and industrial loans outstanding (monthly average) at large commercial banks.

The 1980 recovery, however, proved an exception to this rule--loan demand did not drop, interest rates did not stay down, and the expansion was choked off at an early stage. The fear now is that something similarly perverse will happen this time around. Thus, it would pay to take a look at the 1980-81 experience--at Federal Reserve action in particular--to seek clues as to how the 1982-83 recovery will or will not proceed.

In the third quarter of 1980, the Fed jacked up the money supply at a torrid 15% annual rate (see Chart 3). Providing the banking system with so much liquidity zapped short-term interest rates down fast. Then, to compensate for runaway growth, the Fed downshifted so that the money

Chart 3. Boomeranging Money Growth, Churning Interest Rates

<u>Year/Quarter</u>	<u>Money Supply Growth (% Change, Annual Rate)</u>	<u>Prime Rate</u>	<u>Commercial & Industrial Loans (\$ Billions)</u>
1980 I	7.0	16.4%	\$161.2
II	-3.0	16.3	160.2
III	14.6	11.6	162.8
IV	11.3	16.7	170.9
- 1979:IV to 1980:IV	7.3		
1981 I	4.7	19.2	172.8
II	9.5	18.9	177.0
III	0.2	20.3	185.8
IV	5.9	16.9	191.6
1980:IV to 1981:IV	5.0		
<u>Year/Month</u>			
1981 Dec.	12.8	15.8	193.7
1982 Jan.	23.8	15.9	197.6

supply advanced by only 5% at an annual rate in the first quarter of 1981. This money squeeze came at the same time that business was borrowing heavily in response to quickening economic activity. As a result, rates boomed up once again.

The money pace, reversing field again, picked up in the second quarter of 1981. But then the Fed once more slammed on the brakes--the money supply barely rose at all in the third quarter, giving rise to another bout of prime rateitis. The monetary authority subsequently eased up, and interest rates in the fourth quarter eased up, too.

Riding the Fed's roller coaster has thus given the economy some serious scares in the past two years. And now the situation is ominous once again, as a glance at the money growth figures for December and (especially) January will show. Money mushroomed at the end of last year

and the beginning of this year, which means that money growth may be set for yet another roller-coaster ride down hill. In fact, if the Fed intends to stick to its growth target of 5% or less for the year (fourth quarter of 1981 to the fourth quarter of 1982), the money supply will grow barely at all for the rest of this year!

Such a course would surely be disastrous; it is therefore assumed that the monetary authority will bend its 5% rule a bit, at least enough to keep the prime from climbing much higher than 20% late in the year when the economy is heating up. Yet in order to maintain its credibility on the inflation-fighting front, the Fed will not likely bend its rule too much.

As a consequence, interest rates are expected to stay high well into the future. And that means the recovery will at best be somewhat less than average. At worst, it could mean another recession in 1983.

Those Devastating Deficits

Another, perhaps the overriding, reason that interest rates will stay high and threaten the recovery is that there is no end in sight to the U.S. Treasury's huge presence in credit markets. The Administration that one year ago promised a balanced budget by 1984 is now counting cumulative future deficits in the hundreds of billions. The loss of credibility implied by these numbers means that lenders and investors, already highly cautious due to seesawing interest rates, will become even more cautious and protective. Reasoning that gargantuan deficits will lead to higher inflation (via increased money creation), higher interest rates (via excess demand for funds), or both, lenders will refuse to accept anything but sky-high interest rates on their money.

The government may be able to produce studies showing that budget deficits do not cause inflation or higher interest rates. But if money market participants believe that huge deficits are bad, then the Reagan deficits will in fact keep interest rates up. Moreover, even if deficits in the past were not necessarily linked to high rates of inflation and interest, history may not be much of a guide in an era when the prime rate almost routinely hits 20% and when it is a cause for rejoicing when the inflation rate gets down to 8%. In other words, if the economy is currently outside of historical experience, the effect of huge budget deficits may be hard to determine.

Nonetheless, it seems clear that with so many people now sensitized to and fearful of deficits, the economy can only fare worse than it did in past periods when deficits were big. A quantitative picture of those previous deficits versus today's predicament is given in Chart 4.

Not only will the 1982 deficit of \$100 billion or so set a record in dollar terms, it is also expected to be extraordinarily high as a percent of GNP. Perhaps more foreboding is the fact that for several years in a row, beginning in 1980, plugging the deficit hole has and will require a big chunk of the nation's financial resources. Not coincidentally, perhaps, the last few years have also been savaged by high interest rates and sluggish economic growth.

Thus, if the Reagan Administration and Congress do not act to reduce the currently budgeted deficits, interest rates will probably not decline much in the foreseeable future. In fact, they could rise swiftly, stomping even harder on the housing and auto industries,

Chart 4. The Deficit Ante Rises

<u>Years</u>	<u>Federal Deficit</u> <u>as % of GNP</u>
1953	1.9%
1954	1.5
1955	surplus
1956	surplus
1957	surplus
1958	2.3
1959	0.2
1960	surplus
1961	0.7
1962	0.8
1963	surplus
1964	0.5
1965	surplus
1966	0.2
1967	1.6
1968	0.7
1969	surplus
1970	1.3
1971	2.0
1972	1.4
1973	0.4
1974	0.8
1975	4.5
1976	3.1
1977	2.4
1978	1.4
1979	0.6
1980	2.3
1981	2.1
1982 (est.)	3.2
1983 (first half est.)	2.8

already flat on their backs. In that case, unemployment would continue upward, causing government expenditures to rise further; at the same time, weak economic activity would mean lower than expected government revenues, again exacerbating the deficit. The vicious cycle of deficits leading to high interest rates leading to slow economic growth and unemployment leading to high deficits would persist.

The obvious places at which to stop this cycle are the Social Security and military budgets. In an election year, Social Security is almost certainly untouchable. That leaves defense--the only program that hasn't been put under the gun, a program widely perceived to be bloated, and thus the most likely candidate for significant budget cuts.

Even whacking the Pentagon by 10%, however, would only reduce the fiscal 1983 deficit by some \$20 billion. Nonetheless, cuts in defense could make it politically possible to make cuts elsewhere; simultaneously, military cuts would tell Wall Street that deficits can be and will be controlled. If, instead, President Reagan decides to sacrifice his economic program to his plans for a military buildup, 1983 may be another tough year for most businesses.

There is one safety valve. While erratic money supply growth has kept investors' fears up and thus contributed to keeping interest rates up as well, the overall slowdown in money expansion has helped quell inflation. If the combination of fairly tight money, recession, and continued oil price weakness pulls the inflation rate down further, as expected, the resulting gap between inflation and interest rates could become so wide that lenders may be willing to accept a lower nominal return on their money. In this case, interest rates could subside even in the face of big deficits, and economic expansion would work to pare those deficits.

This turn of events is the one hoped for by the Administration. The problem is that much as it tries, the Fed cannot control the money supply with pinpoint accuracy. So further jagged money patterns can be expected, and these--along with the mammoth deficits--will keep financial markets jittery. Under such conditions it's hard to see a

significant, sustained decline in interest rates. And that, in turn, means it's hard to see a significant, sustained recovery from the 1981-82 recession--at least with the budget policy that's now in place.

Summary

Recovery from the 1981-82 recession is on the way, due in large part to the Reagan tax cuts set for July.

But the Reagan budget deficits may help turn the recovery into yet another recession.

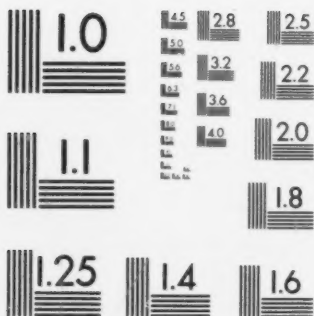
For if companies made optimistic by the recovery go running after funds while huge budget deficits persist, interest rates could render another terrible verdict on the economy. Jumpy, sluggish money growth could make things even worse. In short, the 1982-83 economy could be set for a rerun of 1980-81, when recovery from the first-half 1980 recession wilted in the face of towering interest rates.

Thus, actions taken by the President, the Congress, and the Fed in the coming months will be extremely important in determining how the recovery will fare and what the economy will do in 1983. More than ever, the future is in the hands of the nation's economic policymakers.

NATIONAL PRODUCT ACCOUNTS AND KEY ECONOMIC INDICATORS
(Billions of Dollars)

	Actual 1981	-----Forecast-----						-----Annual-----	
		1982				1983		1981	1982
National Product Accounts	4Q	1Q	2Q	3Q	4Q	1Q	2Q		
Gross National Product	2984.8	3008	3071	3155	3264	3368	3454	2922.2	3124.8
Consumer Spending	1909.5	1946	1989	2040	2093	2152	2207	1858.1	2017.1
Gross Private Domestic Investment	443.6	423	435	458	495	528	546	450.6	452.7
Fixed Investment	426.0	425	440	458	485	513	528	432.4	451.9
Nonresidential	332.6	332	336	346	360	374	385	327.1	343.5
Residential	93.4	93	104	112	125	139	143	105.3	108.4
Inventory Change	17.6	-2	-5	0	10	15	18	18.2	0.8
Government Purchases	615.7	621	630	643	662	673	684	589.6	639.1
Federal	246.7	246	250	256	268	273	278	228.5	255.1
State & Local	369.0	375	380	387	394	400	406	361.1	384.0
Net Exports	16.0	19	17	14	14	15	17	23.8	15.9
Real GNP (1972 Dollars)	1495.4	1481.8	1486.9	1500.5	1522.7	1541.9	1553.1	1509.4	1498.3
(% change at annual rate)	-5.2	-3.6	1.4	3.7	6.1	5.1	2.9	2.0	-.7
Implicit Price Deflator									
(% change at annual rate)	8.4	7.0	7.2	7.4	8.0	7.8	7.5	9.1	7.7
Key Economic Indicators									
Unemployment Rate (%)	8.4	9.3	9.5	9.4	8.8	8.1	7.8	7.6	9.2
Housing Starts (thousands of units)	871	930	1060	1150	1340	1470	1440	1085	1120
Consumer Price Index									
(% change at annual rate)	7.8	6.2	6.5	6.5	7.4	8.0	7.9	10.3	7.4
90-Day Treasury Bill Rate (%)	11.75	12.0	11.5	11.5	12.0	13.0	14.0	14.0	11.8
AA Bond Rate (%)	14.82	15.1	14.1	14.0	14.0	14.8	14.9	14.3	14.3
Consumer Durables Spending	226.4	230	240	245	257	265	272	232	243
(billions of dollars)									

Data other than interest rates are seasonally adjusted at an annual rate.



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U.S. BUSINESS OUTLOOK, SHORT-TERM

The economy, like a patient who has survived the worst ravages of a disease, is finally ready to recover:

- . Business chucked off inventories at a record pace in the first quarter of 1982, leaving stocks lean and well under control. That means companies' reorder rates will soon be up, which in turn means suppliers will soon begin to raise output.
- . The inflation rate has dropped substantially in recent months and is not likely to spurt anytime soon. That means whatever income gains consumers make will translate into real purchasing power. In fact, real consumer spending jumped nearly 3% in the first quarter even though real gross national product (GNP) dropped 4.3% at an annual rate.
- . The July 1 tax cut coupled with the 7.4% Social Security benefit boost on the same date will help consumers further by putting some \$40 billion (annual rate) into their pockets. Even if consumers decide at first to save a lot of that extra money, spending on consumer goods will still show a pick-up.
- . Defense spending will be strong.

Conclusion: The economy is not dead; it will very soon be showing signs of life. Some growth will even occur this quarter, to be followed by real advances of about 4% annually late this year and into 1983.

But, again like the surviving patient, the economy cannot regain full vigor after only a short recovery. Even if the 4% growth forecast is correct, the unemployment rate a year from now will still be over



8%; and industry's capacity utilization rate will still be far below desired levels.

In short, even with the projected recovery in 1982, the economy that enters 1983 will be running well under its potential, leaving many resources idle.

That situation mightn't be terrible if it were certain that business would improve through 1983 and beyond. But unless interest rates descend from the stratosphere, a sustained recovery is highly chancy.

Which leads back to the intricate budget ballet that has enjoyed such a long run this season in Washington. They've been at it for a half-year now, yet the D.C. dancers don't seem to have tired out, and no one has managed to choreograph a final act. Until that performance ends, the economic script for the post-recovery period must remain in abeyance too.

The Great Inventory Bust of 1982

In almost every economic swing, inventories play a pivotal role. At the end of the sharp 1973-75 recession, for example, business slashed inventories, thereby shoving real GNP down at an 8% annual rate in the first quarter of 1975. Without this inventory reversal, real GNP would not have fallen at all. In other words, final demand--consumption, fixed investment, government spending, and net exports--had stopped dropping in the first quarter of 1975, signaling the start of recovery.

Similarly, in the first quarter of 1982 final demand actually increased even though real GNP dropped a sharp 4.3% (annual rate). Once again, the GNP decline was due to an inventory swing--in 1982's

first quarter, inflation-adjusted business inventories fell at a record \$17.2 billion annual rate. That topped the previous record in 1975's January-March period by \$3 billion.

It's a good thing that this huge inventory runoff is behind us, since cuts in inventory mean cuts in new orders followed by cuts in production, employment, and income. The crucial question now is whether more inventory reductions are in store that will further depress economic activity, or whether companies will start restocking and thus give output a lift. In short, what role will inventories be playing in the 1982 economy?

The only previous case that remotely resembles the inventory tumble of 1982's first quarter was the 1975 experience. Some salient inventory statistics from both periods are presented in Chart I.

Chart I. At Recession's End, Inventories Tumble

		<u>Change in Inventories</u>	<u>Change in Real Inventories</u>	<u>Inventory/ Final Sales</u>	<u>Real Inventory/Sales</u>
1974:	IV	15.4	12.9	4.26	3.59
1975:	I	-14.3	-14.3	4.07	3.55
	II	-14.6	-11.3	3.99	3.48
	III	2.1	1.0	3.96	3.43
1981:	III	27.5	14.9	3.98	3.27
	IV	9.4	4.2	3.97	3.31
1982:	I	-39.3	-17.2	3.83	3.24

NOTE: Inventory change data are seasonally adjusted at an annual rate.

In 1974, as business scrambled for raw materials and as the underlying weakness of the economy remained somewhat hidden by this

scramble, inventories got built up substantially. The ratio of inventories to final sales got badly out of line, indicating that firms had overstocked.

Companies addressed that problem by cutting inventories deeply in the first half of 1975 as shown in Chart I. The chart also shows that this reduction cut the inventory/sales ratio. By the third quarter of 1975 business actually added a little to inventories, yet this small addition represented a sharp swing from the previous large cuts. And that swing helped real GNP shoot up 9.3% at an annual rate.

The situation today is in some ways better than it was in 1975, and in some ways worse. It's better in that inventories today are relatively lean: Chart I shows that even before the stunning inventory rundown in 1982's first quarter, the inventory/sales ratio this time around is much tighter than in 1974-75. Thus another steep decline, as occurred in 1975's second quarter, seems improbable. The forecast calls for nominal inventories to drop by \$7 billion at an annual rate in the second quarter, which would be about \$3 billion in real terms. This relatively small decline would act as a brake on the slide in production and employment, and would contribute importantly to growth in 1982's second quarter.*

*The perversity of a decline in inventories in 1982's second quarter helping to boost GNP can be looked at in two ways. One way is through arithmetic: An inventory change that goes from -\$40 billion in 1982's first quarter to -\$7 billion in the second quarter is an increase of \$33 billion: $-7 - (-40) = +33$. The other way to view the situation is via economics: GNP measures total output of goods and services in the country. Part of that output may go to inventory--goods that have been produced (thus sustaining employment and income) but not yet sold. If inventories drop by \$40 billion, it means \$40 billion worth of goods that were sold were not replaced--i.e., production was cut back to the tune of \$40 billion (causing employment and incomes to decline). If inventories then drop by only \$7 billion in the next quarter, most sales would be met by current production,

So that's what's good about inventories now--they'll help boost GNP and kick off the recovery. What's worse about inventories is their cost. The prime rate in 1975's first quarter was 9% and was on the decline. The prime is now around 16%. The upshot: High carrying costs will keep inventory building to a minimum. Inventory accumulation will not, therefore, be much of a boon to growth once the current swing is completed.

Inventory building was fairly weak in the second half of 1975, too, because inventories were far too high for the volume of sales. But in other recovery years inventories rose faster--e.g., 1954, 1958, 1961, 1970. In general, real inventory accumulation in those years perked up about two quarters after recovery started. In recovery from the 1981-82 recession, no significant real increase in inventories is expected until three or four quarters after the turning point.

The Consumer in Shining Armor

An inventory swing should kick off a recovery in the second quarter of 1982. But inventory building will be sluggish, and so cannot pull the recovery too far forward.

which in fact would increase from the previous quarter. The numerical example below should clear the picture, with the numbers representing unit sales, and keeping in mind that production equals unit sales plus change in inventory. Even with a drop in sales in period 3, production rises because instead of meeting many sales out of inventory, sales are being met by current production.

<u>Period</u>	<u>Inventory Level (End of Period)</u>	<u>Change In Inventory</u>	<u>Sales</u>	<u>Production</u>
1	300	0	100	100
2	260	-40	80	40
3	253	-7	70	63

Traditionally, housing helps boost recoveries because by the end of recession interest rates are usually down and people take advantage by locking into long-term mortgages at attractive rates. The current recession, of course, requires a separate chapter in the recession record book. Mortgage commitment rates are down, yes, but from 18% last fall to 17% at present. At 17%, few people qualify to buy an average house in the U.S. So with demand low, builders have little incentive to start new units. Thus, housing cannot lead this recovery.

It's possible for government spending to help a recovery along. On the state and local level, however, governments are strapped for tax revenues, and they can't expect any help from the federal government. The feds, meanwhile, are working to cut nondefense spending growth. Defense spending on the other hand, will boost GNP even if it is cut in the fiscal 1983 budget. The reason is that most cuts would affect military outlays beyond 1983; spending that will occur through 1983 has to a large degree already been committed. But even with significant military outlays, government spending as whole will not be strong enough to lead the recovery.

Since business capital spending never leads, and since a strong dollar will help keep net exports down, that leaves the consumer as the only possible white knight to conquer the recessionary dragon.

And, in fact, the consumer is not a bad candidate for the job. For as Chart II shows, real consumer spending usually manages to grow every year (even when overall GNP is slipping). Major case in point: Real GNP fell a sharp 1.1% in 1975, while real consumption jumped 2.2%.

The major weapon the consumer needs to combat recession is income. Thus far in 1982, real per capita income has bounced around

from month to month. On average it was down in the first quarter; but it rose in February and March (see Chart II) as the inflation rate fell, thus leaving people with more of their income gains intact. On the other hand, with unemployment rising, income growth in the near future cannot be vigorous. (Income is being propped up now by interest income and transfer payments.)

Besides income, consumers also need liquidity if they are to loosen their purse strings. One measure of liquidity is consumer installment credit relative to personal income. As Chart II shows, this measure grew rapidly from 1975 to 1979--i.e., consumers were taking on large amounts of debt, putting a strain on their financial positions. At some point, however, people reach a debt limit and they try to get spending back in line with income. This so-called reliquefaction process has now been going on for some two years, so that the credit/income ratio today is well below its 1979 peak. Thus consumers are much less burdened with old debt than they were two years ago, and are in a better position to take on new debt.

Another measure of liquidity is the amount of money people have in savings. The more people have saved, the more secure they will feel spending out of current income; in addition, money in the bank can be withdrawn if people want to spend more than their current income permits. Looking at real per capita savings in Chart II, it can be seen that as consumers retrenched in 1980 they increased saving, but to a level well below the early 1970s. Real per capita savings then dropped last year, but rebounded in the first quarter of 1982.

Chart II. The Consumer Gets Ready to

<u>Year</u>	<u>% Change In Real Consumption</u>	<u>End of Period Installment Credit Outstanding As % of Personal Income</u>
1970	2.2%	12.59%
1971	3.7	12.74
1972	5.8	12.98
1973	4.3	13.49
1974	-0.6	13.20
1975	2.2	12.63
1976	5.6	12.94
1977	4.9	13.78
1978	4.7	14.46
1979	2.9	14.80
1980	0.5	13.46
1981	2.5	13.15
1981: I*	5.8	13.35
II	-2.1	13.37
III	3.3	13.22
IV	-2.2	13.15
1982: Jan.*	3.2	13.11
Feb.	10.2	13.03
Mar.	-9.5	NA

*Quarterly and monthly data at seasonally adjusted annual rates

**Savings deflated by deflator for personal consumption expenditures

NA-Not Available.

to Spend

% Change In Real
Personal Income Per Capita

Real Savings**
Per Capita (Dollars)

2.8%	\$294.0
2.4	302.9
2.9	250.6
5.8	352.5
-1.7	342.2
1.0	348.6
2.6	287.5
2.5	241.0
3.4	230.0
1.9	235.9
-0.4	248.6
1.2	241.1
2.1	206.1
0.5	242.7
1.6	237.2
0.5	278.2
-4.4	236.3
6.3	227.9
3.5	278.2

ate.
nditures.

In sum, through the first quarter of 1982:

- . The consumer debt position looks pretty good, although continued caution due to high unemployment may still keep people from borrowing much to finance increased spending.
- . Real income is growing. But in part the recent growth represents recovery from a disastrous (snow-blasted) January and increases in transfer payments. High unemployment will put a cap on income gains in the short term.
- . The level of savings is low compared to a decade ago, but has been trending up in recent years.

Putting all of this together points to so-so growth in consumer spending, certainly not enough growth to spark a significant economic recovery. But with the big tax cut rolling in to support the consumer, the forecast turns more upbeat. The 10% reduction in personal tax rates set for July 1 will add some \$30 billion (annual rate) to consumer incomes. The 7.4% increase in Social Security benefits will tack on another \$10 billion at an annual rate.

These two cash injections combined will cause a spurt in disposable personal income. And even if a big chunk of the income increase is saved, as assumed, real consumer spending is expected to rise 2%-3% (annual rate) in the third quarter after declining in the second. By the fourth quarter of this year, consumers will likely be more accustomed to their higher after-tax income, and will consequently spend a larger share of it. Thus consumer spending in the fourth quarter is projected to grow faster than in the third quarter.

Big Downside Risks in 1983

So after an inventory swing puts the economy onto a growth track in the second quarter, consumer spending is expected to ride to the rescue in the third and fourth quarters.

Meanwhile, interest rates are projected to trickle down somewhat. That's because the inflation rate is way down; and it's expected to stay down as the Federal Reserve Board sticks to its money targets, as wage growth slows due to the soft economy, and as plentiful supplies keep price increases modest in the key food and energy sectors. Interest rates are also expected to fall in the near term as loan demand softens. (The huge inventory rundown in the first quarter coupled with cutbacks in capital spending should reduce business' demand for funds.) By the middle of the year a pickup in cash flow should also be helping out with business' supply of funds.

The small decreases projected in interest rates will still leave them at historically high levels. So while the housing industry should be near the end of its current collapse, persistently high mortgage rates will allow only a feeble housing recovery at best.

High rates will also keep car sales in the slow lane. If cars and houses stay depressed, it raises the question of how long interest rates will stay at levels that prevent a strong recovery and an ensuing healthy expansion.

Since around last Thanksgiving, when the Administration acknowledged that federal budget deficits would hit \$100 billion, the answer to the interest rate riddle has resided in Washington. To date, budget compromise efforts have amounted to a lot of sound and fury signifying little. If, in fact, little does come of the compromise

negotiations, the Congressional Budget Office projects a fiscal 1983 deficit of around \$180 billion.

There is no way the financial markets could swallow \$180 billion of Treasury debt without getting ill. If full-blown expansion is to get underway in 1983, deficits will likely have to be kept under \$100 billion, perhaps a lot lower. And future mammoth deficit projections will have to be believably scaled back--by reducing military and Social Security budgets, for example.

If the budget deficit debate results in deadlock, deficits as a share of GNP could be larger and last longer than they ever have since World War II. So it is difficult to say what the effect will be on interest rates and on the economy in general. The sure conclusion is that continued failure to fix the budget will hurt the economy. The forecast of 4% real growth in the first half of next year, therefore, assumes that some budget compromise is made to quiet lenders' fears that the Treasury will squeeze financial markets mercilessly or that the Fed will monetize the debt.

If those fears are not quelled, all bets for 1983 are off.

Write Capital Spending Off

While inventories and consumer spending are expected to contribute to economic growth during the remainder of 1982, and while the government and housing sectors could help too, one sector will almost certainly suffer for most of the year--nonresidential fixed investment.

Since last fall companies have seen sales soften, profits plummet, and spare capacity grow. With little incentive to expand, it's not surprising therefore that business has been cutting its capital

budgets. According to McGraw-Hill surveys, firms last fall planned to raise expenditures for new plant and equipment by 9.6% in 1982. A few months later survey respondents said they would increase 1982 expenditures by 6.9%; and in the most recent survey the projection was down to 3.9%. Coupled with respondents' inflation expectations, that translates into a real spending decline of 4.5%. In other words, as the economy progressively worsened, firms cut their capital spending plans.

The prospects for capital investment in the very near term are particularly dismal, as shown by the indicators in Chart III. If

Chart III. No Strength at All in the Short Term

	-----1981-----			-1982-
	2Q	3Q	4Q	1Q
Non-Defense Capital Goods Orders (Billion \$)	287.2	287.8	269.3	257.7
Construction Contracts-Commercial & Industrial (Millions of Square Ft.)	981.7	881.0	862.7	750.0 ^e
Corporate Cash Flow (Billion \$)	270.5	279.2	273.0	254.0
Gross National Product (Billions of 1972 \$)	1510.4	1515.8	1498.4	1482.2
Business Equipment Output (Billions of 1972 \$)	114.9	113.7	110.9	106.7
Industrial Operating Rate (%)	76.9	76.2	71.2	68.1
Interest Rate on Corporate Bonds (%)	14.0	14.9	14.6	15.0

NOTE: Dollar and square foot figures are at seasonally adjusted annual rates.

recovery in the rest of the economy takes hold in the third quarter, however, investment should respond soon thereafter.

The latest McGraw-Hill survey also found that business has fairly strong capital spending plans for 1983, suggesting that companies anticipate a sustained recovery. If no budget compromise is reached, however, and if interest rates consequently remain sky-high, investment plans could be quickly curtailed as they were earlier this year.

Summary

The recession is ending.

In the current quarter, a lower rate of inventory decumulation should help boost production. Then, in the third and fourth quarters of 1982, the tax cut and Social Security boosts should spur consumer spending. Business capital spending could also contribute to economic growth by the end of the year, though in the meantime purchases of new plant and equipment are expected to fall.

Interest rates have trickled down a bit in the second quarter. And even with a recovery projected, rates are expected to fall a little more in the face of weakening loan demand and a relatively low inflation rate. Rates will not drop sufficiently, however, to allow a vigorous recovery in housing.

The greatest danger confronting the economy now is the possibility that rates could take off again. That could happen if the economy heats up late this year while at the same time the Treasury borrows huge sums to finance the burgeoning budget deficit.

If budget politics leads to \$100+ billion deficit estimates well into the future, it's difficult to see how interest rates could come

down much in 1983. On the contrary, financial market participants-- even though they've already factored large deficits into their plans--might get so spooked that rates next year could soar again. Then the Reagan administration would have to confront its third recessionary year in a row.

NATIONAL PRODUCT A
(Bill

	Actual 1982 <u>1Q</u>
<u>National Product Accounts</u>	
Gross National Product	2991.6
Consumer Spending	1945.1
Durables	236.5
Nondurables	761.6
Services	946.9
Fixed Investment	430.7
Nonresidential	337.3
Structures	135.1
Producers Durable Equipment	202.2
Residential	93.5
Inventory Change	-39.3
Government Purchases	626.5
Federal	254.0
Defense	170.2
Nondefense	83.9
State & Local	372.5
Net Exports	28.6
Real GNP (1972 Dollars)	1482.2
(% change at annual rate)	-4.3
Implicit Price Deflator	201.84
(% change at annual rate)	3.5

Key Economic Indicators & Assumptions

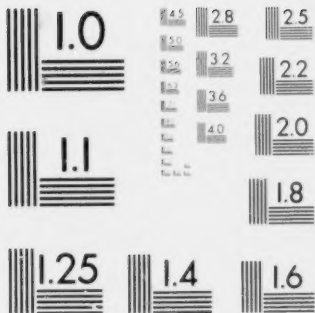
Unemployment Rate (%)	8.8
Housing Starts (thousands of units)	924
Consumer Price Index	
(% change at annual rate)	3.2
90-Day Treasury Bill Rate (%)	12.9
Bond Yield (%)	15.0
Personal Income (\$ Billions, SAAR)	2511.3
Disposable Personal Income	
(\$ Billions, SAAR)	2113.0
Saving as % of Disposable Income	5.5

SAAR-Seasonally Adjusted Annual Rate

ACCOUNTS AND KEY ECONOMIC INDICATORS

(in millions of Dollars, SAAR)

-----Forecast-----						
1982			1983		----Annual----	
2Q	3Q	4Q	1Q	2Q	1981	1982
3040	3104	3193	3279	3368	2925.5	3082.2
1968	2007	2056	2104	2151	1857.8	1994.0
234	239	248	254	260	232.0	239.4
766	775	788	802	818	743.2	772.7
968	993	1020	1048	1073	882.6	982.0
423	428	454	476	498	434.4	433.9
330	331	344	356	368	328.9	335.6
133	132	134	136	138	125.7	133.5
197	199	210	220	230	203.1	202.1
93	97	110	120	130	105.5	98.4
-7	3	6	10	20	16.2	-9.3
632	642	657	670	684	591.2	639.4
256	261	270	277	285	230.2	260.3
176	183	189	195	202	154.3	179.6
80	78	81	82	83	75.9	80.7
376	381	387	393	399	361.0	379.1
24	24	20	19	15	26.0	24.2
1486.1	1495.5	1512.6	1529.0	1546.0	1510.3	1494.1
1.1	2.6	4.7	4.4	4.5	2.0	-1.1
204.56	207.56	211.10	214.45	217.85	193.71	206.26
5.5	6.0	7.0	6.5	6.5	9.2	6.5
9.5	9.5	9.3	9.0	8.5	7.6	9.3
900	960	1150	1300	1350	1084	984
2.3	4.6	6.1	6.3	6.5	10.4	5.5
12.0	11.0	10.5	10.0	11.0	14.1	11.6
14.0	13.5	14.0	14.0	14.0	14.2	14.1
2537	2571	2621	2684	2753	2404.1	2560.1
2138	2198	2237	2287	2341	2016.0	2171.5
5.5	6.2	5.6	5.5	5.6	5.3	5.7



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U.S. BUSINESS OUTLOOK, SHORT-TERM

August 16 to 20--that was the week that was on Wall Street. Prices and volume surged, interest rates sank, spirits soared.

It seems clear that the stock market rocketed because of the much-ballyhooed interest rate drop and because Wall Street wizards predicted further sharp declines in rates. Accurately predicting interest rates is a chancy affair at best; but those who are supposed to know about such matters argue that rates will continue their descent through the first half of 1983.

That sounds great for the stock market, and for the economy as a whole. But there's a big catch to this scenario: The reason the wizards give for the interest rate bust is continued economic sluggishness--no one, in other words, will be borrowing money because business will be so bad. That will allow the U.S. Treasury to borrow well over \$100 billion and still leave interest rates some breathing space.

The forecast in this report takes another tack: It assumes that a modest recovery is now underway and that the economy will continue to grow at a 3%-4% annual pace next year. Once companies' capital spending and inventory plans react to rising sales, borrowing will pick up and the

interest rate slide will come to an end, probably in this year's fourth quarter.

Meanwhile, with the Treasury tromping about the financial markets in order to cover the government's mammoth deficits, interest rates will start moving up again early next year. The rise is not expected to be swift enough to throttle the recovery, but it is expected to push the President and Congress into further deficit-reducing actions. Once accomplished, these actions will push interest rates lower toward the end of 1983 and thus let the recovery continue.

The Recovery Looks Real...

With some Wall Streeters optimistic on interest rates because they're pessimistic on the economy, what is the evidence to the contrary?

For starters, shored up by the tax cut and a boost in Social Security benefits, disposable personal income in July shot up 2% and consumer spending rose 1%. The gap between income and spending growth represents a big increase in saving. So consumers are in good shape to do even more spending in coming months.

Secondly, housing starts went up a startling 33% in July, probably indicating that the housing slide is over.

On the business-to-business side of the economy, new orders for durable goods perked up in July by 3%. Importantly, new orders for nondefense capital goods--a barometer of business investment--surged by 10%.

And in the political sphere, Congress passed the tax bill that will cut the federal deficit by \$98 billion in the next three years. While

experts still expect deficits to exceed \$100 billion in the next few years, this latest tax measure shows that politicians including the President himself have woken up to the deficit threat. Thus further action can be anticipated if interest rates rebound next year and start to push the economy into another slump.

...But Not Robust

That's the good news, good enough it seems to undermine the argument that the economy is still in recession. But at the same time there's no shortage of bad news--for example, industrial production continued to fall in July; car sales still sag; inventories probably remain too high.

Even within the good news there's some bad news mixed in. The big housing starts rise in July is particularly suspect, given that it was powered by new construction of multi-unit projects; single-family home construction went nowhere in July. Meanwhile, sales of new houses continued to tumble in the second quarter, depositors continued to take more money out of thrifts than they put in, and mortgage rates remain at high levels. (A statistical bird's-eye view of housing's problem is .. presented in Chart I.) Moreover, even with the interest rate fall in the money and bond markets, it's not likely that mortgage rates will fall nearly as fast. The reason: Beleaguered thrifts won't want to get stuck once again with mortgages made at rates that turn out to be too low.

The upshot is that housing starts in the foreseeable future will not get anywhere close to the two million level, where demand unconstrained by today's financial straitjacket would quickly push them.

Chart I. Housing Prospects Remain Dim

Year/Quarter	New Home Sales (000s)*	Mortgage Rate (%)	Net New Deposits at Thrifts (\$ Millions)	Housing Starts (000s)*
1981 I	510	15.4	-659	1399
II	444	16.2	-10,467	1173
III	358	17.3	-12,625	962
IV	402	17.9	-1,652	865
1982 I	385	17.5	-561	920
II	361	17.3	-8,076	956
July	NA	17.2	NA	1211

*Seasonally adjusted annual rate.

The bad news in July's strong capital goods data is that new orders are still way below where they were just a few months ago. So it's not likely that capital spending is yet set for a splurge.

The bad news in the personal income numbers is that July wages and salaries rose by less than half a percent, so consumers may well hang on to their tax cuts awhile longer before thinking of letting go the purse strings. That caveat is particularly pointed in view of historically high unemployment rates.

All in all, therefore, it's not appropriate at present to belt out "Happy Days Are Here Again." But at the same time, the economy doesn't require a funeral dirge either. The consumer is starting to spend; housing has reached the cellar and has nowhere to go but up; companies will soon begin to build inventories in response to rising consumer sales, and by early next year they will likely begin to increase real investment in new plant and equipment.

The key threat to this scenario--and the key reason why the scenario isn't stronger--is still interest rates. Yes, rates dropped rapidly in August, and headlines may have given the impression that the interest rate gridlock had finally given way. But long-term rates remain

high, and all rates could rise again in 1983 as the economy strengthens and as the government finances its deficit. The key to easing the gridlock remains in the hands of the politicians: The forecast of sustained economic expansion in 1983 is premised on Washington again acting to cut the projected deficits down from mammoth to merely big.

Deficits the Key to '83

During a recession, the federal budget deficit typically rises as tax revenues decline and government support payments (like unemployment insurance) increase. Thus, the fact that the fiscal 1982 budget is in deficit is no cause for alarm.

What is cause for alarm is that projected deficits in the next several years are huge--not only in dollar terms but also as shares of gross national product (GNP). As Chart II shows, deficits in the first

Chart II. The Deficit is a Growth Industry

<u>Period</u>	<u>Cumulative Deficit (-) (\$ Billions)</u>	<u>Deficit as % of GNP</u>	<u>Comments</u>
1951-55	+ 5.9	surplus	Korean War; 1953-54 recession
1956-60	0.0	0.0	1957-58, 1960 recessions
1961-65	-10.6	0.4	Tax cuts of 1962 and 1964
1966-70	-25.0	0.6	Vietnam; Great Society; 1969-70 recession
1971-75	-125.2	1.9	1973-75 recession
1976-80	-204.7	1.9	1980 recession; transfer payments surge
1981-85	-402.8	2.3	Military buildup; Social Security; tax cuts

NOTE: Except for 1981-85, the data are on a National Income Account basis. The 1981-85 data refer to fiscal years and are from the Administration's 1983 budget proposal.

half of the 1980s are put at 2.3% of GNP. (The percentage could easily come in higher since it is based on possibly over-optimistic Administration assumptions.) That means the government will be hogging its biggest share of national savings since World War II. And that means unless the economy sinks into another recession in 1983, growing demand for funds from business to buy capital goods and inventories and from consumers to buy cars and dish washers will bump heads with demand from the Treasury. Ergo, interest rates will rise. (For the long-term relationship between deficits, inflation, and interest rates see Chart III.)

Chart I*II. Deficits and Rates Rise Together

Period Average	-----Deficits-----		Prime Rate	Bond Yield	Inflation Rate
	\$ Billions	% of GNP			
1961-65	\$ 2.1	0.4%	4.5%	4.5%	1.6%
1966-70	5.0	0.6	6.7	7.2	4.2
1971-75	25.0	1.9	7.6	8.5	6.6
1976-80	40.9	1.9	10.1	9.7	7.2

Congress and the President have belatedly begun to understand the long-run connection between deficits and interest rates; consequently, they recently enacted the \$98 billion tax increase/expenditures cutting bill. But once is not enough. The budget hemorrhage in 1983, 1984, and 1985 is still expected to run well over \$100 billion a year, in part because some of the deficit-reducing moves had already been factored into previous deficit projections. For example, the new bill cut Medicare outlays by about the amount assumed in the Administration's February budget proposal.

With interest rates still high in early 1983 and beginning to rise, Congress is expected to take some action on the biggest and fastest growing pieces of the budget--Social Security and defense. According to Administration projections, these two categories will account for nearly two-thirds of the whole federal budget by 1985. Since interest on the debt must be paid and will account for some 12% of federal expenditures, there will be little room to cut elsewhere if the very biggest programs remain sacrosanct.

Hence Social Security and defense will finally have to come under the budgeters' guns--to the extent that financial market participants can reasonably believe that deficits beyond 1983 will come down. Without such cuts the entire federal pie could not shrink very much; the deficit albatross would thus again hang around the neck of Wall Street, interest rates would again march upward, and the economy would again sag.

Rates Are Off the Roller Coaster

The argument above says the economy is recovering, hence private plus public demand for credit could drive interest rates up once again. A counter argument is that business' finances are in such a dismal state that companies won't be buying much plant and equipment and they won't build inventories so they won't compete against the government for funds.

Business' balance sheet is undoubtedly weak, even relative to conditions at the end of the severe 1973-75 recession. A sampling of financial indicators at the end of the 1973-75 and 1981-82 recessions is presented in Chart III. Compared to the mid-70s recession, corporations at the end of the recent recession were less liquid, more burdened by

Chart III. The Balance Sheet Blues

	<u>1975:I</u>	<u>1982:I</u>
Current Ratio (Current Assets/Current Liabilities)	1.648*	1.415
Liquidity Ratio (Current Assets Minus Receivables & Inventories/Current Liabilities)	0.332*	0.295
Cash Flow (% Change, Annual Rate)	-27.7	-25.8%
Net Interest Payments/Cash Flow	.175	.237
Commercial & Industrial Loans (% Change, Annual Rate)	-1.3	20.4
Net New Issues of Corporate Bonds (\$ Billions)	13.0	7.7
Long-Term Bond Interest Rate	8.7	15.0

*1974:IV

interest payments, more dependent on short-term financing, and less able and willing to sell long-term debt.

In recent weeks, however, the growth of short-term debt has abated somewhat; the drop in interest rates will ease the interest payment burden a little and could spur some revival of the bond market; and unless the recovery aborts very soon, cash flow will improve, further reducing the need for short-term borrowing. Thus financial hardship is not viewed as an insurmountable obstacle to recovery.

Poor balance sheet conditions will not vanish overnight, however, and will continue to constrain corporate purchases. Thus, as the comparison in Chart IV makes clear, the upcoming improvement in business investment (and the economy as a whole) is hardly expected to be robust. Which is bad and good. It's bad because employment and income

Chart IV. The 1982-83 Recovery Compares Unfavorably

% Change, Annual Rate, Real Business Fixed Investment

Quarters	1975	1982	1976	1983
I	-23.4%	- 5.0%	8.3%	3.0%
II	-9.3	-12.4	7.1	6.0
III	4.8	-15.0	11.1	6.5
IV	1.3	-1.0	4.8	6.0
YEAR	-12.2	-4.4	9.4	0.0

Change in Business Inventories, Billions of 1972 \$

Quarters	1975	1982	1976	1983
I	-\$14.3	-\$15.6	\$10.0	\$4.0
II	-11.3	-4.7	11.3	5.0
III	1.0	-2.0	7.3	7.0
IV	2.3	2.0	2.4	10.0
YEAR	-6.7	-5.1	7.8	6.5

% Change, Annual Rate, Real GNP

Quarters	1975	1982	1976	1983
I	-8.2%	-5.1%	9.0%	3.7%
II	5.0	1.3	2.7	3.3
III	9.3	3.0	2.3	3.7
IV	3.7	3.6	3.8	4.0
YEAR	-1.1	-1.3	5.4	3.4

growth will remain relatively low. It's good because in the private sector's collision with the Treasury the economy will not be totaled.

Another argument against a sustained modest recovery leading to a modest rise in interest rates centers on the Federal Reserve Board. In 1980, it is noted, interest rates roller-coasted down in the third quarter only to surge to new heights within a few months. The reason was that after seeing the money supply shrink in the spring of 1980 when

credit controls were instituted, the Fed let go the floodgates. Money spurted forth, driving interest rates down. Then the Fed tightened up again, and in conjunction with high inflationary expectations the result was another surge in rates.

For the past two months, the argument goes, the Fed has been easy, pushing rates down. Lower rates will lead to more borrowing, growth in the money supply beyond the Fed's targets, and thus another round of monetary tightening that will cause rates to jump yet again.

This scenario is not considered likely for two reasons: One is that on a monthly basis the money supply has not grown much since April and is within the Fed's growth target; so on that score the Fed doesn't have to restrict money supply growth in coming months. Second, Fed policy seems to have gained credibility in the past year, especially with regard to bringing down the inflation rate. With more confidence in the Fed, markets are not as likely to swing wildly; and with inflation having tapered off to the 6%-7% range, the inflation premium in interest rates should not be as big as it was two years ago when inflation was chugging along at double-digit rates.

The forecast in this report, therefore, rejects both the argument for a sharp runup in rates as well as the opposite argument for a sharp rundown.

Summary

That interest rates have fallen this summer is not surprising (given that recessions typically weaken loan demand). That rates fell so swiftly in August is surprising. But the August tumble should not be taken as a sign that the economy is on its knees and is on the way down. The economy may be on its knees, but it is on the way up.

Recent economic statistics--like personal income, housing starts, and nondefense capital goods orders--all show strength. And the interest rate slide can only help.

The key element in the recovery right now is consumer spending. With personal income and savings up, and interest rates down, consumers are expected to come through. Once that happens, business should respond by building inventory and investing in new plant and equipment. Housing, too, should help out, although starts are expected to remain low by historical standards.

The key threat to sustained recovery is interest rates, recent drops notwithstanding. With federal budget deficits over \$100 billion, heavy Treasury borrowing next year coupled with private sector demand for funds could push rates up once again, and once again the economy could sag.

To avoid this outcome, Congress and the President must act again to pare the federal deficit, probably focusing on Social Security and defense. If such moves are made, at least to the extent that deficits in 1984 and 1985 can realistically be put at under \$100 billion, then the economy next year is projected to grow at better than 3%. If such moves are not made, this recovery--like the one in 1980-81--may not last very long.

NATIONAL PRODUCT ACCOUNTS AND KEY ECONOMIC INDICATORS
(Billions of Dollars, SAAR)

National Product Accounts	Actual 2Q	-----Forecast-----						-----Annual-----		
		1982		1983						
		3Q	4Q	1Q	2Q	3Q	4Q	1981	1982	1983
Gross National Product	3041.2	3105	3181	3257	3336	3420	3513	2937.7	3080.7	3381.5
Consumer Spending	1945.8	1988	2029	2069	2115	2168	2224	1843.2	1970.6	2144.1
Durables	240.2	246	252	257	262	268	274	234.6	244.0	265.3
Nondurables	755.0	767	778	790	805	825	846	734.5	762.3	816.5
Services	950.6	975	999	1022	1048	1075	1104	874.1	964.3	1062.3
Fixed Investment	447.0	442	449	465	481	494	506	451.1	447.7	486.6
Nonresidential	351.9	342	345	353	363	374	385	346.1	349.5	368.8
Structures	143.9	142	141	144	146	149	152	129.7	142.6	147.8
Producers Durable Equipment	208.0	200	204	209	217	225	233	216.4	206.9	221.0
Residential	95.2	100	104	112	118	120	121	104.9	98.2	117.8
Inventory Change	-17.4	-5	5	10	15	20	28	20.5	-13.3	18.3
Government Purchases	630.6	648	668	683	693	710	731	596.9	644.2	704.3
Federal	244.5	256	270	278	281	290	303	228.9	255.1	288.0
Defense	176.1	183	191	198	205	212	221	153.7	179.1	209.0
Nondefense	68.5	73	79	80	76	78	82	75.2	76	79.0
State & Local	386.0	392	398	405	412	420	428	368.0	389.1	416.3
Net Exports	35.1	32	30	30	32	28	24	26.1	32.1	28.5
Real GNP (1972 Dollars)	1475.3	1486.2	1499.5	1513.1	1525.6	1539.6	1554.9	1502.6	1482.9	1533.3
(% change at annual rate)	1.3	3.0	3.6	3.7	3.3	3.7	4.0	1.9	-1.3	3.4
Implicit Price Deflator	206.14	208.92	212.14	215.25	218.67	222.14	225.93	195.51	207.72	220.50
(% change at annual rate)	4.9	5.5	6.3	6.0	6.5	6.5	7.0	9.4	6.2	6.2
Key Economic Indicators & Assumptions										
Unemployment Rate (%)	9.5	9.7	9.5	9.2	8.9	8.6	8.1	7.6	9.4	8.7
Housing Starts (thousands of units)	956	1057	1150	1300	1325	1300	1300	1084	1021	1306
Consumer Price Index										
(% change at annual rate)	4.4	8.2	4.1	6.2	7.5	8.7	7.4	10.4	6.3	6.6
90-Day Treasury Bill Rate (%)	12.3	9.5	8.0	8.5	9.5	10.5	10.0	14.1	10.7	9.6
Bond Yield (%)	14.5	13.5	12.5	12.5	13.0	13.5	13.0	14.2	13.9	13.0
Personal Income (\$ Billions, SAAR)	2553.5	2606	2647	2701	2765	2843	2911	2415.8	2579.3	2805.0
Disposable Personal Income										
(\$ Billions, SAAR)	2154.5	2212	2239	2276	2322	2410	2460	2029.1	2180.7	2367
Saving as % of Disposable Income	6.9	7.6	6.9	6.6	6.4	7.6	7.1	6.4	7.0	6.9

SAAR-Seasonally Adjusted Annual Rate